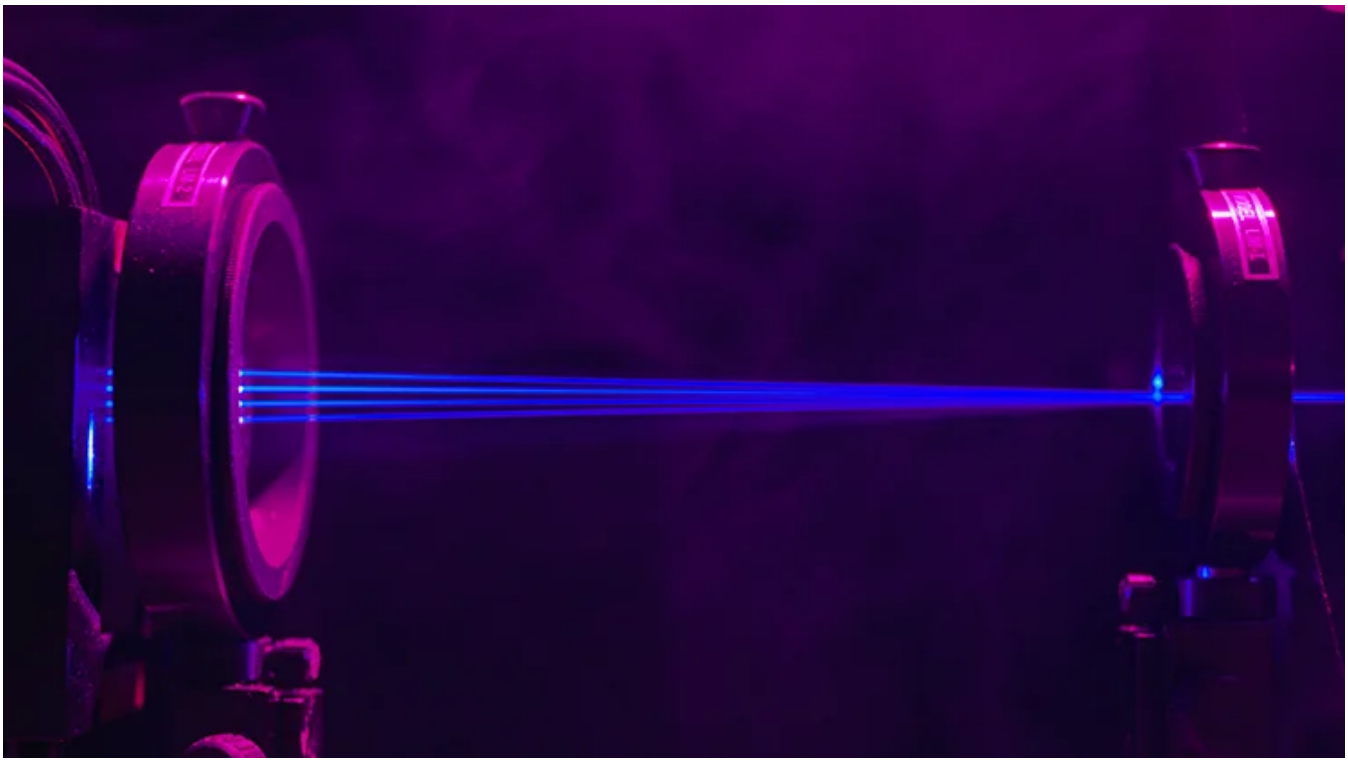
Nathan Hughes on bank diversity and the financial system

By Perpetual Asset Management

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The high-profile failure of Silicon Valley Bank (SVB) and the forced marriage of Credit Suisse and UBS in March were followed by concerns for the health of San Francisco-headquartered

First Republic Bank in April. But while the liquidity crunch has had a big impact on a slew of US regional lenders, what does it mean for the Australian financial system in the longer term?

For Nathan Hughes, Portfolio Manager of the ESG Australian Share Fund and Income Share Fund, there are several lessons to be learnt from these examples and the regulators' quick action to provide backstops and prevent wider contagion. Deposit holders emerged largely unscathed although the experience for equity holders was undoubtedly worse.

"Such events serve to highlight the inherent risks in banking, which at its simplest involves raising equity capital from shareholders, levering that capital up multiple times with further debt capital and customer deposits, lending that money out to borrowers and hoping to get it all back at some point in the future," said Hughes. "A small group of bad assets can become a big problem for shareholders given this level of gearing."

In such high-profile cases, the reflexive response may be to look for parallels between US bank runs and Australian banks, which may then be amplified and exacerbated by social media and the ability to transact online. Hughes notes that while there are similarities between the US and Australian banking systems, there are also key differences.

"The predominantly floating rate nature of our mortgage market means interest rate risk, while present, is not of similar scale to the US market, where mortgages are typically fixed for 30 years," he said. "SVB was also exposed to a concentrated deposit base of venture capital style investors, funding start up or unprofitable businesses, who all needed access to their money at the same time. The interplay of these two issues is what led to the crisis of confidence and the 'run on the bank'. Australian major bank deposit bases are in general terms far more diverse."

However, there is still plenty of risk, not least the instability inherent in fractional reserve banking systems. Consider the fact that a large bank like SVB lost around 25% of its deposits in one day. Fractional reserve banking cannot handle something like this no matter how well capitalised a bank is.

Hughes added that Australia's reliance on offshore funding markets has declined as a percentage of total funding but does still exist. This is more likely to be felt in periodic pressure on the cost of funds, rather than a complete freeze in availability. This risk is more acute for non-bank financials who are very reliant on friendly wholesale funding and securitisation markets to fund their lending.

"On the lending side, credit risk in Australia is quite concentrated in one particular asset class – residential mortgages – which is really a giant trade on interest rates and unemployment. Risks sit in the extremes of the portfolio, and this is something I am aware of given our investment in Helia," he said. "This discussion is not intended to sound overly alarmist but mainly to highlight certain fragilities that do exist within highly leveraged institutions. Capital

and liquidity ratios today are strong, but things can and will go wrong in future. Cycles do happen."

Hughes added that the potential for low frequency, high severity events are always in the back of his mind when constructing a portfolio. This is especially relevant given the concentration of the Australian banking system where the big four banks and Macquarie have just under 80% of the deposits. This compares to the US where the top four have around 45% of the deposits.

"Simply following a passive benchmark weight in the four major Australian banks would equate to almost 18% of your portfolio in one correlated investment (despite their subtle differences), which frankly feels like poor risk management, unless of course valuations are absolutely and unequivocally compelling," he said. "It is difficult to make that case today with slowing credit growth, sticky costs, and the prospect of rising bad debts."

For Hughes, the most attractive bank currently when considering return profiles, current multiples, capital strength and credit provisioning is National Australia Bank. This is his largest bank holding and the only overweight position held by his funds in the sector.



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